Primacy of fair market value assessments in intragroup share transfers

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Introduction

In the recent case of *Bray Controls South East Asia Pte Ltd v. Commissioner of Income (International Taxation), W.P.(C) 17911/2024*, the Delhi High Court (the "**HC**") examined an intragroup transfer of shares and highlighted the importance of a legally compliant valuation report in determining tax liability in India.

The petitioner, Bray Controls South East Asia Pte Ltd ("**Bray Sing**"), a company incorporated in Singapore and a tax resident there, proposed to purchase the shares of an Indian company, Bray Controls India Private Limited ("**Bray Ind**"), from another affiliated group entity, Bray International Incorporated ("**BII**"), a tax resident of the United States. To facilitate this transfer, Bray Sing applied for a nil withholding tax certificate under Section 195(2) of the Income Tax Act, 1961 (the "**IT Act**"), contending that the transaction would not result in any capital gains taxable in India.

Background

The Assessing Officer ("**AO**") rejected the request for a nil withholding tax certificate and directed that tax be withheld at 10% of the total consideration. In doing so, despite Bray Sing clarifying that no benefits under the India-Singapore tax treaty were being sought, the AO proceeded on the assumption that Bray Sing might claim such benefits.

Aggrieved by the AO's order, Bray Sing invoked Section 264 of the IT Act and filed a petition seeking a revision of the AO's order. In this petition, the Commissioner of Income Tax ("**CIT**") concurred with the AO's conclusion but on different grounds. The CIT noted that Bray Sing had not furnished a valuation report of the fair market value ("**FMV**") of the shares of Bray Ind at the time of their original acquisition by BII. However, in response to the notice under Section 264 of the IT Act, Bray Sing had submitted the latest valuation report on record dated December 12, 2022, reflecting the FMV as INR50.25 (Indian Rupees Fifty and Twenty-Five Paise) per share. This conflicted with the agreed transaction price of INR100 (Indian Rupees Hundred) per share, thereby creating ambiguity regarding the genuineness of the proposed sale price.

The CIT further observed that that as the shares were unlisted and Bray Sing had not furnished historical financials or valuation data, the capital gains tax liability was not accurately ascertainable. As a result, the CIT concluded that the tax should be withheld at 10% of the transaction value.

The HC ruling

The HC ruled that the historical cost of acquisition of shares of Bray Ind by BII was not relevant to determine whether the current transfer would trigger capital gains tax.

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The HC clarified that the focus should have specifically been on:

- the sale consideration now agreed upon for the proposed transfer to Bray Sing;

- whether the sale consideration matched the FMV of the shares computed in accordance with Rule 11UA of the Income Tax Rules, 1962 (the "**IT Rules**"), on a proximate date; and

- the historical cost at which the shares were acquired by BII.

For context, as per Rule 11UA(1)(c)(b) of the IT Rules, the FMV of unquoted equity shares on the valuation date is determined through the net value asset value or book value method. This approach relies on the book value of a company's underlying assets and liabilities as reflected in its audited financials, rather than speculative projections of future income.

In the present case, both the AO and the CIT, failed to apply this statutory framework for valuation. Instead, the AO and the CIT focussed on the valuation in respect of the price paid by BII at the time of its acquisition of Bray Ind's shares, although that transaction: (i) was not under scrutiny in the current assessment year; and (ii) was not relevant to determine whether the proposed transfer of shares from BII to Bray Sing would give rise to capital gains.

For the purposes of Bray Sing's application for a nil withholding tax certificate, the authorities were required to confine their examination to the contemporaneous transaction and take into account the agreed transfer price, the fair market value of the shares under Rule 11UA of the IT Rules, and the original cost of acquisition of BII.

Therefore, the HC set aside the impugned order and remanded the matter to the CIT for fresh consideration.

Our comments

Multinational groups often undertake internal restructuring exercises to achieve operational efficiencies, align business structures, or meet regulatory requirements. In relation to transactions involving Indian subsidiaries, it becomes imperative to follow Rule 11UA of the IT Rules and base the transaction value on a chartered accountant's formal valuation report. It is clear from this case that Indian tax authorities can seek data or valuations that may not be relevant to the transaction at hand, which can delay simple transactions and expose parties to the risk of interim tax withholding. In addition, this has the effect of increasing compliance costs and can also affect cash flow. Following the letter of the law is, therefore, critical.

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